IN THE HIGH COURT OF JUDICATURE AT BOMBAY

ORDINARY ORIGINAL CIVIL JURISDICTION

INCOME TAX REFERENCE NO. 140 OF 1988

Vissanji Sons & Co. Limited,)
9, Wallace Street, Fort,)
Bombay 1.) ...Applicant

V/s.

The Commissioner of Income-tax,)
Central I, Bombay.) ...Respondent

Ms.Aarti Vissanji with Mr.S.J. Mehta for Applicant.
Mr.Parag Vyas for Respondent.

CORAM : V.C. DAGA AND
A.S. AGUIAR, JJ.

DATED : SEPTEMBER 30, 2005.

ORAL JUDGMENT (PER V.C. DAGA, J.) :-

. This reference under Section 256(1) of the Income-Tax Act, is at the instance of the Revenue, arising out of the order in ITA No.423/Bom/83 dated 30th November, 1984 passed by the Income-tax Appellate Tribunal, Mumbai (the Tribunal for short) for the Assessment Year 1978-79; whereby the following substantial question of law has been referred for the opinion of this Court "-

"Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was justified in holding that only the cumulative preference dividends relating to the previous year amounting to Rs.65,000 could be deducted in working out the undistributed income, which was liable to additional income-tax under Section 104 of the income-tax Act, 1961?"

Facts :

2. The facts giving rise to the present reference in nutshell are that the assessee is a company in which the public are not substantially interested. The Income-tax Officer during the course of assessment found that the statutory requirement of distribution of dividend as laid down under Section 104 ought to have been in the sum of Rs.1,61,300/- but the company distributed dividends in the sum of Rs.1,30,000/- only and, that too, by way of cumulative dividend on preference shares for two assessment years ended on 31st March, 1977 and 31st March, 1978 respectively.

3. The Income-tax Officer not being satisfied with explanation offered by the assessee, in exercise of powers under Section 104 of the Act subjected the assessee-company to additional income-tax on undistributed income. When the matter was taken up in appeal by the assessee, the Commissioner of Income-tax (Appeals) held that considering that the assessee-company was burdened with the distribution of Rs.1,30,000/- on account of cumulative payment of dividend on preference shares alongwith the liability on account of payment of income-tax in the sum of Rs.68,250/- for the earlier years, the declaration of larger dividends would have been unreasonable. The Commissioner of Income-tax (Appeals) was also of the opinion that utilisation of the reserves created for declaration of dividend could not have been the proper decision from the point of view of the prudent businessman. The Commissioner of Income-tax (Appeals), therefore, cancelled the order passed under Section 104 subjecting the assessee-company to additional income-tax on undistributed income.

4. Being aggrieved by the aforesaid order of the CIT (Appeals), revenue preferred an appeal before the Tribunal. The Tribunal for the reasons recorded in the order in general and in paras 5 and 6 in particular, was pleased to set aside the order of the CIT (Appeals) and restored the order of the Income Tax Officer. The observations made by the Tribunal while setting aside the order of the Commissioner of Income Tax (Appeals) reads as under :-

> "The words 'smallness of profit' occurring in section 104(2)(i) refer to the Commercial profits made by the company and not the statutory dividends which have to be declared in order to meet the requirements of section 104. Viewed in this context, whether the declaration of larger dividends was unreasonable or not, has to be considered with reference to the commercial profits or the distributable income or both. It is not under dispute that the distibutable income has been correctly worked

out by the Income-Tax Officer at Rs.2,68,837/-, while the commercial profit according to the audited profit and loss account of the assessee-company, is Rs.2,63,748/- after providing for taxation. Thus, whichever way the matter is looked into, the profit of the assessee-company exceeded Rs.2,60,000/-. It is not the case of the assessee-company that there was any financial stringency or any other such circumstances on account of which the assessee-company could not declare larger dividends. On the other hand, the Profit & Loss Appropriation Account of the assessee-company shows that the assessee-company has added Rs.2,00,000 to the general reserve in this very year. Considering all these and looking to the totality of the facts and circumstances, we have no hesitation in coming to the conclusion that no case has been made out why the distribution of larger dividends would have been unreasonable and the levy of additional income-tax on undistributed income was perfectly justified.

6. We now deal with the alternative submission that in working out the undistributed income on which additional income-tax was to be levied, the entire dividend distributed during the 12 months immediately following the expiry of the previous year should have been taken into consideration and not merely the dividend in respect of the pervious year. Here again we find that Section 104(1) talks of the distribution of dividend in respect of the previous year. This means that it is only the dividend in respect of the previous year which has to be considered and not also the dividend relating to an earlier year. Viewed in this context, it is not under dispute that the dividend on cumulative preference shares relating to this year was only Rs.65,000/-. The Income-tax Officer therefore rightly deducted from the distributable income only the dividend distributed relating to this year amounting to Rs.65,000/- for working out the additional

income-tax on undistributed income."

5. The Assessee, not being satisfied by the aforesaid order of the Tribunal was successful in seeking reference to this Court giving rise to the present reference proceedings.

Submissions :-

6. Ms.Vissanji, learned Counsel appearing for the applicant submits that the dividend on preference shares for the previous year ended on 31st March, 1977 and 31st March, 1978 declared were in the sum of Rs.1,30,000/- for two years. According to her, it was obligatory on the part of the assessee-company to declare and distribute accumulated dividend on cumulative preference shares as per the provisions of the Companies Act. That is how dividend for two years were declared by the assessee-company following provisions of the Companies Act.

7. Ms.Vissanji to reinforce her submission contends

that as per the provisions of the Companies Act, share capital is of two types i.e (1) Preference Share Capital; and (2) Equity Share Capital. Preference Shares again are of two types i.e. (a) Cumulative Shares; and (b) Non-cumulative Preference Shares. If right to dividend lapses, then the shares are called Non-cumulative Preference Shares and shares in respect of which the dividend goes on accumulating, then such shares are called Cumulative Preference shares. Whether they are of one category or other, depends upon the terms of issue. Unless there is term against accumulation, preference shares are presumed to be cumulative. The reliance is placed on the Judgment in the case of **Webb V/s. Earle (1875) LR 20 Eq.556** in support of this submission.

8. Ms.Vissanji submits that the presumption of accumulation can be ruled out only by a very carefully drafted clause, like this that dividend will be paid out of the profits of the company made in each year. If the intention is not clear, the presumption of accumulation will prevail. According to the Judgment of the Madras

High Court in the case of **M.F.R. D'Cruz v. K.N. Vishwanathan, (1941) 11 Com Cases 277 : AIR 1941 Mad 806**, preference shares confer the right to the fixed accumulative dividend at specified rate payable out of distributable profits. With this understanding of the concept of share capital, it would be relevant to turn to clause 5 of the Memorandum of Association of the assessee-company to find out the nature of preference shares issued by the assessee-company. The said clause reads as under :-

> "The capital of the Company is Rs.50,00,000/- divided into 2000 Preference Shares of Rs.1000/- each and 3000 Ordinary shares of Rs.1000/- each capable of being increased or reduced in accordance with the Company's regulations and the legislative provisions for the time being in force in this behalf and such Preference Shares shall confer the right to a fixed cumulative preferential dividend at the rate of 5 per cent per annum, free of income-tax on the capital for the time being paid up thereon and shall rank in

> a winding up as regards return of capital and payment of arrears of dividend down to the commencement of the winding up whether earned or declared or not in priority to the Ordinary Shares but shall not confer the right to any further participation in profits or assets and upon any increase of capital the Company is to be at liberty to issue any new shares with any preferential, deferred, qualified or special rights privileges or conditions attached thereto."
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> (Emphasis supplied)

9. The above clause unequivocally goes to show that the preference shares issued by the company have conferred right to a fixed cumulative preferential dividend at the rate of 5% per annum, subject to the terms mentioned therein. Thus, one can safely reach to the conclusion, on the facts of this case, that the shares in question on which the dividends were declared were cumulative preference shares. Owing to the lack of profits in one year or for want of decision of the

directors, if the profit has not been distributed in that year, the preference share holders remain unpaid either partly or wholly (In this case, wholly). Therefore, the holders of the cumulative preference shares of the assessee-company were entitled to the dividend for two assessment years one ended on 31st March, 1977 and other ended on 31st March, 1978.

10. In the aforesaid premises, if the assessee-company has declared and paid dividend for the aforesaid two years, then no fault can be found with the declaration and payment of such dividend. The assessee company was in law bound to make such payment of dividend, as such in our considered view they were justified in claiming deduction in the sum of Rs.1,30,000/-.

11. Having recorded above finding, we have no alternative but to hold that the substantive finding recorded by the Tribunal finding fault with the order of the CIT (Appeals) and resorting to restore the order of the ITO is erroneous. However, we affirm and restore

the alternative finding recorded by the I.T.O. under Section 104 of the Act holding that the dividend on accumulated preference shares actually distributed within twelve months immediately following the expiry of previous year amounting to Rs.1,30,000/- fell short by above 1% (approx) on statutory requirement considering the capital of Rs.25 lakhs. The Directors having regard to the profits made by the assessee-company and its general reserve should have declared dividend much higher than that actually declared. In that view of the matter, the I.T.O. was perfectly justified in seeking approval of the I.A.C. (Com.), Range-I, Bombay, as envisaged under Section 107 of the Act to levy an additional tax. However, the I.T.O. while subtracting the dividend from the distributable profit ought to have deducted or subtracted Rs.1,30,000/- and not Rs.65,000/- only. As such correct re-calculation would be necessary in the light of this Judgment and Order.

12. Thus, the shortfall in declaring dividend would carry additional income tax as required by Section 107 of the Act. The question referred, in the light of the

findings recorded herein, is answered in favour of the assessee and against the Revenue.

. The reference. accordingly, stands disposed of with no order as to costs.

(A.S. Aguiar, J.) **(V.C. Daga, J.)**